



---

January 2004

## Energy Regulation

Gaye White

---

### Recommended Citation

Gaye White, *Energy Regulation*, 57 SMU L. REV. 923 (2004)  
<https://scholar.smu.edu/smulr/vol57/iss3/17>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

# ENERGY REGULATION

*Gaye White\**

## Table of Contents

I. INTRODUCTION .....	923
II. ELECTRIC UTILITY CASES.....	923
A. OVERVIEW OF DEREGULATION OF THE TEXAS ELECTRICITY MARKET .....	923
B. CHALLENGES TO PUC RULES AND ORDERS.....	924
1. <i>Price to Beat</i> .....	924
2. <i>Stranded Costs Recovery</i> .....	927
3. <i>Transmission and Distribution Rates</i> .....	938
4. <i>Annual Reports</i> .....	941
5. <i>Consumer Protection</i> .....	943
6. <i>Wholesale Transmission Rules</i> .....	946
7. <i>CCN Approval</i> .....	949
C. NEGLIGENCE .....	951
D. CONTRACTS .....	952
III. LEGISLATION.....	955
A. ELECTRIC UTILITY .....	955
B. GAS UTILITY.....	957
IV. CONCLUSION .....	958

## I. INTRODUCTION

THIS article reviews judicial and legislative developments in Texas law related to electric and natural gas utilities from January 1, 2003 through November 1, 2003. The cases examined include decisions of courts of the State of Texas. The majority of the significant cases discussed in this article focus on the interpretation and implementation of statutes and rules relating to the deregulation of the electric utility industry in Texas.

## II. ELECTRIC UTILITY CASES

### A. OVERVIEW OF DEREGULATION OF THE TEXAS ELECTRICITY MARKET

In 1975, the Texas Legislature enacted the Public Utility Regulatory Act (“PURA”) in order to “establish a comprehensive and adequate reg-

---

\* B.S., Texas A&M University, 1995; J.D., University of Texas, 2000. Associate, Thompson & Knight, L.L.P., Austin.

ulatory system for electric utilities to assure rates, operations, and services that are just and reasonable to the consumers and to the electric utilities.”<sup>1</sup> The PURA created a state agency to regulate utilities, the Public Utility Commission of Texas (“PUC”). The PUC set rates for electric utilities with the objective of providing utilities an opportunity to earn a reasonable rate of return on their invested capital and recover reasonably incurred expenses, subject to their provision of just and reasonable rates to retail customers.

In 1999, the Texas Legislature passed Senate Bill 7 to deregulate the electric generation market and permit certain electricity providers to compete for customers. Senate Bill 7 amended the PURA and provided for a transition period from a regulated to a deregulated system. Senate Bill 7 included provisions ensuring that Texas electric customers will receive lower prices and better service in a competitive market.

Under the regulated electric system, a single utility generated electricity, built and maintained the electricity distribution grid, and sold electricity to consumers. In the deregulated market, those three functions are “unbundled” into three separate entities: power generation companies, transmission and distribution utilities, and retail electric providers (“REPs”).<sup>2</sup> The REPs sell the power generated by the power generation companies through the distribution system maintained by the transmission and distribution utilities.

Deregulation of the Texas electric utility industry went into effect on January 1, 2002. Although the PUC continues to oversee many aspects of the transition, market forces, rather than government regulation, now dictate the prices for the production and sale of electricity to both wholesale and retail customers. In a fully deregulated market, REPs will charge Texas electric customers market-based rates rather than rates set by the PUC.

## B. CHALLENGES TO PUC RULES AND ORDERS

### 1. *Price to Beat*

Texas has maintained some control over electricity rates during the transition to a deregulated pricing system by requiring affiliated REPs to charge a special discounted rate to certain classes of customers.<sup>3</sup> This rate is known as the “price to beat” and is set by the PUC at “six percent less than the affiliated electric utility’s corresponding average residential and small commercial rates . . . in effect on January 1, 1999.”<sup>4</sup> Affiliated

---

1. TEX. UTIL. CODE ANN. § 31.001(a) (Vernon 1998).

2. TEX. UTIL. CODE ANN. § 39.051 (Vernon Supp. 2004).

3. As of January 1, 2000, each privately-owned monopoly utility was required to divest itself of its retail electricity sales activities and assign those functions to an REP. *Id.* Where the transmission, generation, and retail activities of a former monopoly utility continue to be held by a common holding company, the resulting REP is known as an “affiliated REP.” REPs that are not a part of a former utility held in a common holding company are known as “competitive REPs.”

4. TEX. UTIL. CODE ANN. § 39.202(a) (Vernon Supp. 2004).

REPs are required to “make available” the price to beat to qualifying customers from January 1, 2002, the first day of competition, until January 1, 2007.<sup>5</sup> They may not charge rates that are lower than the price to beat until the earlier of either January 1, 2005, or the date on which “the commission determines that 40 percent or more of the electric power consumed by [qualifying customers] is committed to be served by nonaffiliated retail electric providers.”<sup>6</sup>

In *State v. Public Utility Commission*,<sup>7</sup> the State of Texas, on behalf of Texas state colleges, challenged a PUC order that state colleges are not entitled to benefit from both the price-to-beat rate reduction and the twenty percent rate discount traditionally given to state colleges. In 1995, when retail electric service was still fully regulated, the Texas Legislature enacted Section 36.351 of the PURA. This section requires all utilities to provide to state-funded four-year universities, upper-level institutions, technical colleges, and colleges “a [twenty]-percent reduction of the utility’s base rates that would otherwise be paid under the applicable tariffed rate.”<sup>8</sup> Upon enactment of Senate Bill 7, the legislature altered the structure of the electric-power industry and the nature of the rates that would be applicable to state colleges in those areas of Texas open to competition. Senate Bill 7 contains uncodified Section 63 which requires affiliated REPs to continue to offer electric service to state colleges for a period of almost six years, as provided in Section 36.351.<sup>9</sup> They must provide these services at a rate that is no higher than the applicable rate on December 31, 2001, the final day of regulation.<sup>10</sup>

The PUC and affiliated REPs claim that the legislature intended to preserve a subsidized discount of twenty percent for state colleges rather than subjecting them to the competitive market with its less favorable price-to-beat reduction of six percent.<sup>11</sup> The State, on the other hand, believed it was the legislature’s intent that state colleges receive both the traditional twenty percent discount and the six percent price-to-beat rate reduction. The State argued that state colleges are not expressly excluded from the price-to-beat provision, contending specifically that “no one disputes that the residential and small commercial accounts of [the state colleges] were already receiving, on January 1, 1999, a rate discounted by twenty percent,” and therefore that “the rate effective on January 1, 1999 must be discounted by an additional six percent to arrive at the price-to-beat rate for state colleges which happen to qualify as residential or small commercial accounts.”<sup>12</sup> Looking at the plain language of the statutes, the court agreed with the PUC’s position that the State’s

---

5. *Id.*

6. *Id.* § 39.202(e)(1).

7. *State v. Pub. Util. Comm’n*, 110 S.W.3d 580 (Tex. App.—Austin 2003, no pet.).

8. TEX. UTIL. CODE ANN. § 36.351(b) (Vernon 1998).

9. Act of May 27, 1999, 76th Leg., R.S., ch. 405, § 63, 1999 Tex. Gen. Laws 2543, 2625.

10. *Id.*

11. *Pub. Util. Comm’n*, 110 S.W.3d at 587.

12. *Id.* at 585.

interpretation disregards the phrase “[n]otwithstanding any other provision” in Sections 36.351 and 63, as well as other material language in the provisions. The court found that the PUC’s interpretation is more reasonable and “that the ‘notwithstanding’ language indicates that the twenty percent discount is to operate exclusive of the price-to-beat reduction.”<sup>13</sup>

By making continued application of the twenty percent discount mandatory, the legislature ensured that state colleges would continue to receive the discounted and subsidized rates and would be insulated from the onset of competition. The court held that the PUC reasonably concluded that the legislature sought to benefit Texas state colleges by preserving the more favorable twenty percent discount from the prior regulatory scheme instead of granting them the six percent discount guaranteed in the competitive market by the price-to-beat mechanism.<sup>14</sup>

The State also argued that the PUC failed to comply with its own Rule 25.41(f)(1)(C), which provides that affiliated REPs file both price-to-beat tariffs and documentation supporting the methodology used to determine the price-to-beat rate.<sup>15</sup> The State contended that “[a]bsent any evidence justifying the exclusion of State colleges from the price-to-beat rate reductions, both the statute and the rule require that the January 1, 1999 base rates be reduced by [six percent].”<sup>16</sup> The court disagreed, stating that although Rule 25.41(f)(1)(C) “allows affiliated [REPs] to request development of rates using different methods and different criteria than the price-to-beat requirements set out in Section 39.202,” the rule applies only “to rates that would otherwise be subject to price-to-beat restructuring, [such as] the rates of residential and small commercial customers that are not statutorily exempt from the price-to-beat rate requirements.”<sup>17</sup> The rule does not require providers to justify not developing a price-to-beat for customers who are otherwise exempt.<sup>18</sup>

Finally, the State argued that the PUC “impermissibly delegated to its staff the decision on the certified question” and stated that the commissioners simply adopted the recommendation prepared by the PUC’s Policy Development Division.<sup>19</sup> The court held that staff recommendations may be accepted wholly or in part by the PUC and that, in reviewing the Commission’s order, courts “do not invade the thought processes of the commissioners or speculate about their individual motivations.”<sup>20</sup>

---

13. *Id.* at 587 (quoting Section 36.351 and what will be Section 63).

14. *Id.*

15. *Id.* (referencing 16 TEX. ADMIN. CODE § 25.41(f)(1)(C)).

16. *Id.*

17. *Id.*

18. *Id.* at 588.

19. *Id.*

20. *Id.*

## 2. *Stranded Costs Recovery*

Stranded costs are costs incurred by a utility as a result of investments made under the prior regulatory regime that would not be recoverable in the new competitive market. Before deregulation, a utility could recover over time its reasonably incurred costs of acquiring power-generation assets through rates approved by the PUC and paid by customers. The PUC facilitated this cost recovery by incorporating depreciation expenses into approved rates. In a deregulated market, it was believed that competition might result in rates so low that a formerly-regulated utility would be unable to recover its investments. Stranded costs represent that portion of net book value of an electric utility's generation assets that has not yet been recovered through depreciation and has become unrecoverable in the competitive market. PURA expressly defines stranded costs as "the positive excess of the net book value of generation assets over the market value of those assets."<sup>21</sup>

Chapter 39 of the PURA outlines a three-stage program for the recovery of stranded costs. The first stage provided that the PUC must freeze retail electric rates from September 1999 to December 2001.<sup>22</sup> During this first stage, utilities with identified stranded costs<sup>23</sup> were required to mitigate them through various measures intended to reduce the book value of generation assets, such as shifting depreciation from transmission and distribution assets to generation assets and retaining earnings in excess of the allowed rate of return.<sup>24</sup> The utilities were also permitted to "securitize" a portion of their estimated stranded costs by selling transition bonds and using the proceeds to reduce the book value of generation assets.<sup>25</sup> The costs of issuing and servicing transition bonds are borne by all retail customers in a utility's service area through a nonbypassable "transition charge."<sup>26</sup>

The second stage of stranded cost recovery was implemented as of January 1, 2002, the first day of competition.<sup>27</sup> In this stage, the PUC was authorized to set a nonbypassable "competition transition charge" to allow utilities to recover any stranded costs remaining after the mitigation procedures and securitization utilized in the first stage. These competition transition charges were to be included in the tariffs of a utility's affiliated unbundled transmission and distribution utility.<sup>28</sup> The PUC was directed to revise its previous stranded cost estimates using "updated company-specific inputs" when determining whether to set a competition

---

21. TEX. UTIL. CODE ANN. § 39.251(7) (Vernon Supp. 2004).

22. *Id.* § 39.052(a).

23. In identifying utilities with stranded costs, the PUC used an "Excess Cost Over Market" computer model ("ECOM model"). These identified utilities were reported in the April 1998 Commission Report to the Texas Senate Interim Committee on Electric Utility Restructuring.

24. TEX. UTIL. CODE ANN. §§ 39.254, .256 (Vernon Supp. 2004).

25. *Id.* §§ 39.301-.313.

26. *Id.* §§ 39.302(7), .303(b), (c).

27. *Id.* § 39.201.

28. *Id.* § 39.201(b)(3).

transition charge.<sup>29</sup>

In 2001, estimated stranded cost figures were updated in order to prepare for the rate hearings for transmission and distribution utilities. Unexpectedly, the updated stranded cost estimates indicated that the utilities would have no stranded costs.<sup>30</sup> This development resulted from a substantial increase in natural gas prices in 2000 that had driven the market value of generation assets well above their book value. Some utilities had in fact been overcompensated through their stage one mitigation procedures and securitization. As a result, the PUC ordered the utilities to discontinue all mitigation efforts, to reassign the depreciation transferred from transmission and distribution assets back to those assets, and to return monthly “excess mitigation credits” to retail providers and to their ratepayers. However, the PUC did not require the utilities to refund the proceeds received from selling transition bonds and could not, by statute, modify the transition charge that was imposed on ratepayers to service bonds.<sup>31</sup>

The third stage of stranded cost recovery requires the PUC to conduct a “true-up proceeding” sometime after January 10, 2004.<sup>32</sup> The goal of the true-up proceeding is to determine a utility’s actual stranded costs and to reconcile, or “true-up” this determination with the utility’s previous estimates. The final determination of stranded costs is based on a new calculation of the value of a utility’s generation assets made under actual competitive conditions. The PUC subtracts the market value of a utility’s generation assets from the book value of those assets.<sup>33</sup> If the difference is a positive number, then the utility has stranded costs for which it is entitled to recover. If the difference is negative, then the utility has no stranded costs and the PURA does not provide for the return to ratepayers of any “negative stranded costs.” If the true-up proceeding demonstrates that the utilities over-recovered estimated stranded costs through their earlier mitigation procedures, the PUC is authorized to make appropriate adjustments by reducing the unbundled transmission and distribution utility’s rates.<sup>34</sup> The PUC is not authorized to reduce the transition charge imposed on ratepayers to service transition bonds.<sup>35</sup>

The PURA also requires that the PUC make several other calculations

---

29. *Id.* § 39.201(h).

30. See Tex. Pub. Util. Comm’n, *Application of Reliant Energy for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22355, p. 139; Tex. Pub. Util. Comm’n, *Application of Central Power and Light Company for Approval of Unbundled Cost of Service Rate Pursuant to PURA § 39.201 and Public Utility Commission Substantive Rule § 25.344*, Docket No. 22352, p. 120.

31. TEX. UTIL. CODE ANN. § 39.303(d) (Vernon Supp. 2004) (Transition charges are “irrevocable and not subject to reduction, impairment, or adjustment by further action of the commission.”).

32. *Id.* §§ 39.201(1), .262(c).

33. *Id.* § 39.251(7).

34. *Id.* § 39.201(1)(3).

35. *Id.* § 39.303(d).

in the 2004 true-up proceeding that could affect customer rates.<sup>36</sup> These calculations reconcile previous stranded cost estimates with known values in various areas and result in either credits or bills to the transmission and distribution utility from its affiliated power generation company or retail electric provider. The transmission and distribution utility is to make adjustments to its nonbypassable delivery rates charged to REPs.<sup>37</sup>

a. *Reliant Energy, Inc. v. Public Utility Commission*

*Reliant Energy, Inc. v. Public Utility Commission*<sup>38</sup> held that the PUC exceeded its statutory authority by promulgating a portion of the substantive rule governing the stranded-cost recovery proceeding which allowed the PUC to net a utility's final negative stranded-cost calculation against a positive balance from other true-up items such as a utility's final fuel balance. In the 2004 "true-up" proceeding, the PUC must reconcile the "actual cost of fuel incurred by the utility with the prior estimate used to set the 'fuel factor' component of regulated rates during the final period of traditional regulation."<sup>39</sup> "A positive fuel balance represents money owed to the utility for under-recovered fuel costs."<sup>40</sup> Electric utilities challenged a portion of Rule 25.263 that would reduce the positive fuel balance owed to the utility by any negative stranded-costs, regardless of whether the negative calculation was caused by market forces or by previous over-recovery through securitization.<sup>41</sup>

The utilities contended that there is no such thing as negative stranded-costs and that "the true-up proceeding was never intended to reconcile a negative stranded-cost calculation against a positive fuel balance calculation to reduce the amount due to the utility for under-recovered fuel costs."<sup>42</sup> The PUC, on the other hand, argued "that it has a mandate to prevent a utility from receiving an over-recovery of stranded costs and that offsetting sums due for a positive fuel balance is a permissible means of reversing an over-recovery of stranded costs achieved through securitization."<sup>43</sup>

Rule 25.263 requires the PUC to conduct the following steps in the true-up proceeding:

1. Stranded costs are calculated by subtracting the "market value of the utility's generation assets from the net book value of those assets."<sup>44</sup>
2. The final fuel balance is calculated by subtracting the "estimated cost of fuel that was used to set the utility's rates for the final period

36. *Id.* § 39.262(d)-(g).

37. *Id.* § 39.262(g).

38. *Reliant Energy, Inc. v. Pub. Util. Comm'n*, 101 S.W.3d 129 (Tex. App.—Austin 2003, pet. granted).

39. *Id.* at 136.

40. *Id.*

41. *Id.* (referencing 16 TEX. ADMIN. CODE § 25.263(l)).

42. *Id.* at 136-37.

43. *Id.* at 137.

44. *Id.*



of regulation and the actual cost of fuel for that period.”<sup>45</sup> The stranded costs determined in the first step are then netted against the fuel balance.<sup>46</sup>

3. A “capacity-auction true-up” amount is calculated by subtracting the price the utility was estimated to be able to obtain for its power on the wholesale market in the second stage from the price the utility actually received during the first two years of competition. The capacity-auction true-up amount is netted against the amount reached in the second step.<sup>47</sup>

4. The PUC conducts “a prudence review of regulatory assets not previously approved in a prior [PUC] rate order but [that are] being recovered through securitization in the form of a transition charge or through a competition transition charge imposed during the second stage of stranded-cost recovery.”<sup>48</sup> “If the [PUC] determines that these assets were not prudently incurred, it will subtract them from the true-up balance as determined in steps one through three.”<sup>49</sup>

If the resulting balance from these four steps is positive, the utility is “entitled to recover that amount through a competition transition charge assessed to its transmission and distribution customers.”<sup>50</sup> If the balance is negative, the PUC will “(1) reverse any existing competition transition charge, then (2) reverse any remaining mitigation proceeds, then (3) impose on utilities that have sold transition bonds a negative competition transition charge based on the lesser of the absolute value of the remaining negative true-up balance or the amount the utility has securitized.”<sup>51</sup>

The electric utilities challenged the PUC’s authority to net the final stranded-cost calculation with other true-up items, such as a utility’s final fuel balance. The PUC maintained, however, that “(1) these other true-up items are themselves potential stranded costs and, (2) even if they are not, netting is a permissible means of preventing over-recovery of stranded costs by those utilities that received a windfall through securitization.”<sup>52</sup> The PUC took the position that “because coal, gas, nuclear, and other types of fuel are ‘indisputably assets associated with the production of electricity,’ they constitute generation assets that could become stranded.”<sup>53</sup>

The court rejected the PUC’s attempt to characterize the final fuel balance and the other true-up items as stranded costs. The court observed that the stranded costs and the final fuel balance are determined and re-

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 137-38.

49. *Id.* at 138.

50. *Id.* (referencing 16 TEX. ADMIN. CODE § 25.263(1)(2)(A)).

51. *Id.*

52. *Id.* at 138-39.

53. *Id.* at 139. “Generation assets mean all assets associated with the production of electricity, including generation plants, electrical interconnections of the generation plant to the transmission system, fuel contracts, fuel transportation contracts, water contracts, lands, surface or subsurface water rights, emissions-related allowances, and gas pipeline interconnections.” *Id.* (quoting TEX. UTIL. CODE ANN. § 39.251(3) (Vernon Supp. 2004)).

covered under separate sections of Chapter 39 of the PURA and are treated as distinct concepts rather than the fuel balance being treated as a component of stranded costs. The PURA treats the other true-up items in a similar manner. The court held that the rule netting a negative stranded-cost calculation against a positive balance produced from the other true-up items is not authorized by PURA. Under the statute, utilities are not required to refund negative stranded costs to ratepayers, and the PUC may not require such a refund by calling the other true-up items “stranded costs.”<sup>54</sup>

The court also addressed the PUC’s argument that netting the calculations is a permissible means of preventing over-recovery of stranded costs by those utilities that received a windfall through securitization. PURA mandates that the PUC ensure that no utility over-recover its stranded costs.<sup>55</sup> Relying on its implied powers to reasonably fulfill its express duties,<sup>56</sup> the PUC insisted that “netting the various true-up items is a permissible way to prevent over-recovery [of stranded costs,] effectively forcing the utilities that sold transition bonds based on earlier invalid stranded-cost estimates to disgorge amounts to which they are not entitled.”<sup>57</sup>

The court, however, found the PUC’s rule to be overbroad, explaining that the rule did not “limit the amount by which a negative stranded-cost calculation can offset other positive true-up balances to a utility’s previous over-recovery.”<sup>58</sup> The court’s decision stated that the PUC had the discretion under its implied powers “to net a negative stranded-cost calculation against the other true-up items *only* to the extent that the utility over-recovered stranded costs through securitization.”<sup>59</sup> The PUC “has no statutory authority to net negative stranded costs attributable to market forces.”<sup>60</sup>

The utilities additionally claimed that the PUC exceeded its statutory authority in promulgating a rule that implemented “the partial stock valuation method.”<sup>61</sup> PURA authorizes the PUC to use the partial stock valuation method to establish the value of generation assets when a utility has transferred some or all of those assets to affiliated or nonaffiliated corporations and nineteen to fifty-one percent of the common stock of each such corporation is spun off and sold to public investors through a

---

54. *Id.* at 140-41.

55. *Id.*

56. When the legislature expressly confers a power on a state agency, it also impliedly intends that the agency have whatever powers are reasonably necessary to fulfill its express functions or duties. *Id.* at 141-42 (citing *Pub. Util. Comm’n v. City Pub. Serv. Bd.*, 53 S.W.3d 310, 316 (Tex. 2001)).

57. *Id.* at 142.

58. *Id.*

59. *Id.* (emphasis in original).

60. *Id.* at 143.

61. *Id.*; see TEX. UTIL. CODE ANN. § 39.262(h)(3) (Vernon Supp. 2004); 16 TEX. ADMIN. CODE § 25.263(f)(1)(C).

national stock exchange and traded for at least a year.<sup>62</sup> The PUC calculates “the value of the [generation] assets held by the transferee corporation, presumably an unbundled power generation company, by adding the market value of its common stock to the book value of its preferred stock and its debt.”<sup>63</sup>

The utilities specifically challenged the method employed in the rule to calculate the control premium.<sup>64</sup> Market value of common stock is generally presumed to be the average daily closing price over a period of thirty consecutive trading days, selected by the PUC, with some constraints.<sup>65</sup> The PURA also authorizes the PUC to convene a panel of three financial experts to determine whether a control premium exists for the retained common stock, specifying that “[i]f the panel determines that a control premium exists for the retained interest, the panel shall determine the amount of the control premium, and the [C]ommission shall adopt the determination . . . [but may not increase] *the market value by a control premium greater than [ten] percent.*”<sup>66</sup> However, the PUC’s Rule 25.263(f)(1)(C)(v) provides that the PUC must adopt the panel’s determination of the amount of the control premium, but it “*may not use the control premium to increase the value of the assets by more than [ten percent].*”<sup>67</sup>

The utilities argued that the PURA gives the PUC authority only “to apply the control premium to increase the value of the retained common stock equity by up to ten percent” and claimed “that the rule [was] invalid because it instead allows the [PUC] to apply the control premium to increase by up to ten percent the value of all the corporation’s assets.”<sup>68</sup> The PUC maintained that, although PURA prohibits it employing a control premium greater than ten percent to increase the market value, the statute does not specify to which asset the 10% control premium may be applied. The court disagreed with the PUC, explaining that the rule essentially impermissibly adds the additional language “of all the corporation’s assets” to the statutory phrase “by a control premium no greater than [ten] percent.”<sup>69</sup> The court stated that the meaning of the statute is “unmistakable without such an addition.”<sup>70</sup> A “‘control premium of ten percent’ would naturally increase the value of the retained block of shares by ten percent, [while] ‘a control premium no greater than [ten] percent’ is limited to increasing the value of the retained block of shares

62. *Reliant Energy*, 101 S.W.3d at 143.

63. *Id.* at 143-44.

64. *Id.* at 144. A control premium is the additional value that a block of shares obtains by virtue of the fact that it carries with it the power to control the corporation and is commonly calculated by comparing the aggregate value of the controlling block of shares with the cost that would be incurred if the shares could be acquired at the going market price per share. *Id.* (citing BLACK’S LAW DICTIONARY 1200 (7th ed. 1999)).

65. TEX. UTIL. CODE ANN. § 39.262(h)(3) (Vernon Supp. 2004).

66. *Reliant Energy*, 101 S.W.3d at 144 (emphasis in original).

67. *Id.* (citing 16 TEX. ADMIN. CODE § 25.263(f)(1)(C)(v)).

68. *Id.* at 144.

69. *Id.* at 144-45.

70. *Id.* at 145.

by no more than ten percent.”<sup>71</sup> The court held that the PUC exceeded its statutory authority by promulgating the portion of the rule that would apply the control-premium cap to all of the corporation’s assets.<sup>72</sup>

The court also found that the rule impermissibly allows the PUC to consider not only the valuation panel’s determination of the control premium, but also “other admitted evidence.”<sup>73</sup> The PURA provides that “the determination of the commission based on the finding of the panel conclusively establishes the value of the common stock in each transferee corporation.”<sup>74</sup> The PUC’s rule, however, provides “that the [PUC] is to determine the value of the common stock of the transferee corporation ‘based on the findings of the Commission and *other admitted evidence.*’”<sup>75</sup> The court held that the legislative intent behind PURA was that the panel’s determination of the control premium is conclusive and that the language of the rule improperly allows the PUC to consider whatever evidence it chooses to increase the value of the common stock.<sup>76</sup>

Recovery of stranded costs by utilities that do not securitize their stranded costs may take a number of years. PUC Rule 25.263 allows a utility with stranded costs to recover interest on the true-up balance.<sup>77</sup> Although the rule provides that interest is calculated from the date of the final true-up order until stranded costs are fully recovered, the utilities contended that interest should be calculated from the time the costs became “stranded,” i.e., the first day of competition, January 1, 2002. In contrast, the PUC believed, and the court agreed, that stranded costs come into existence only after the true-up proceeding. While “the book value to be used by the [PUC] at the true-up proceeding is determined as of December 31, 2001, its calculations are to be based on the market value as determined in the proceeding.”<sup>78</sup> The court held that the interest provision of the rule adequately provided the utilities with full recovery of their stranded costs.<sup>79</sup>

Finally, the utilities challenged substantive Rule 25.263(e)(4), which allows the PUC to reduce the net book value of an affiliated power generation company’s generation assets if the PUC determines that the a utility’s successor affiliates have failed to pursue commercially reasonable means of reducing potential stranded costs.<sup>80</sup> The utilities argued “that a

---

71. *Id.*

72. *Id.*

73. *Id.*

74. TEX. UTIL. CODE ANN. § 39.262(h)(3) (Vernon Supp. 2004).

75. *Reliant Energy*, 101 S.W.3d at 145 (emphasis in original).

76. *Id.*

77. 16 TEX. ADMIN. CODE § 25.263(1)(3). “[As a result] of the time value of money, this interest represents a portion of the ‘net, verifiable, nonmitigable stranded costs’ that a utility has a right to recover under chapter thirty-nine.” *Reliant Energy*, 101 S.W.3d at 146.

78. *Reliant Energy*, 101 S.W.3d at 146.

79. *Id.* at 147.

80. *Id.* at 148; see TEX. UTIL. CODE ANN. § 39.252(a) (providing that a utility is only allowed to recover stranded costs that are “nonmitigable”) and § 39.252(d) (requiring “an electric utility . . . [to] pursue commercially reasonable means to reduce its potential

utility's duty to reduce its potential stranded costs ended once it unbundled into successor affiliates [and that the PUC] lacks the authority to reduce the book value of generation assets."<sup>81</sup> The court rejected both arguments and upheld this portion of the rule.<sup>82</sup>

In summary, the court in *Reliant* held that the PUC impermissibly promulgated the portion of Rule 25.263 that (1) unqualifiedly allowed a negative stranded-cost calculation to offset other amounts a utility may become entitled to at the true-up proceeding and (2) in the application of the partial stock valuation method, allowed the PUC to apply the ten percent control-premium cap to the value of all corporate assets and to second-guess the valuation of the panel by considering other admitted evidence.<sup>83</sup> The court upheld the remaining portions of the rule challenged by the utilities.<sup>84</sup>

b. *Entergy Gulf States, Inc. v. Public Utility Commission*

In many cases, stranded costs are attributable to investments in nuclear power plants. *Entergy Gulf States, Inc. v. Public Utility Commission*<sup>85</sup> held that a Texas Supreme Court statement to the effect that there was extensive evidence supporting inclusion in an electric utility's rate base of all costs an electric utility incurred in constructing a nuclear power plant was not "law of the case" as to the issue of whether the utility had established a prima facie case that costs were prudently incurred. Entergy Gulf States, Inc. ("EGSI") appealed a PUC final order denying EGSI a rate increase to recover additional amounts from its share in the construction of the River Bend Nuclear Generating Station ("River Bend"), a nuclear power plant located in St. Francisville, Louisiana. The PUC's denial of EGSI's request was based on EGSI's failure "to present a prima facie case that the additional cost of the plant's construction above the adjusted definitive cost estimate ("DCE")<sup>86</sup> was prudent."<sup>87</sup>

---

stranded costs, including good faith attempts to renegotiate above-cost fuel and purchased power contracts or the exercise of normal business practices to protect the value of its assets"); 16 TEX. ADMIN. CODE § 25.263(e)(4) (If the PUC determines that a utility's successor affiliates "have failed, individually or in combination, to fully comply with their obligations under PURA § 39.252(d), the commission may reduce the net book value of the [affiliated power generation company's] generation assets or take other measures it deems appropriate in the true-up proceeding filed under this section.").

81. *Reliant Energy*, 101 S.W.3d at 148.

82. *Id.* at 148-49.

83. *Id.* at 149.

84. *Id.* at 149-50.

85. *Entergy Gulf States, Inc. v. Pub. Util. Comm'n*, 112 S.W.3d 208, 212-14 (Tex. App.—Austin 2003, pet. filed) (discussing *Gulf States Utils. Co. v. Pub. Util. Comm'n*, 947 S.W.2d 887 (Tex. 1997)).

86. DCE is the 1979 estimate of River Bend's total cost of construction.

87. *Entergy Gulf States*, 112 S.W.3d at 210. The PUC defines the standard of prudence as "[t]he exercise of that judgment and the choosing of one of that select range of options which a reasonable utility manager would exercise or choose in the same or similar circumstances given the information or alternatives available at the point in time such judgment is exercised or option is chosen." *Id.* at 210 n.2.

Construction of River Bend was begun in 1977 and completed in 1986. River Bend then began serving customers in southeast Texas and south central Louisiana. Construction costs were approximately \$4.5 billion, which exceeded the original cost estimate. EGSI was responsible for seventy percent of River Bend's construction costs. In 1986, EGSI (1) sought a rate increase, which would include approximately \$3.15 billion of its River Bend construction costs in its cost of service, and (2) initiated a contested case to determine what portion of its total costs it might include in its rate base as being a "prudent" investment. These two proceedings were consolidated by the PUC in Docket 7195.<sup>88</sup>

The hearing examiners in Docket 7195 included the following conclusions in their report: "(1) \$274 million, or nine percent (later adjusted to 8.3 percent) of the total plant cost should be *excluded* from [EGSI's] cost of service as imprudently incurred; (2) [EGSI's] decision to restart construction of River Bend in 1979, [after a suspension of construction from October 1977 to February 1979] was prudent; and (3) a reasonable DCE, based on information available in 1979, should have been \$2.273 billion ('adjusted DCE'), instead of [EGSI's] 1979 estimate of \$1.729 billion ('original DCE')."<sup>89</sup> The PUC adopted only part of the examiners' recommendations: (1) the decision to build River Bend was prudent and (2) the original DCE should be adjusted upward to \$2.273 billion. Thus, EGSI's "seventy percent share of the prudently incurred cost was \$1.591 billion."<sup>90</sup> Instead of adopting the hearing examiners' recommendation that the PUC disallow only 8.3% of the total plant cost, the PUC deferred its decision on whether EGSI prudently incurred the remaining \$1.453 billion in additional costs because it found the evidence inadequate to support a determination of either prudence or imprudence regarding the construction costs in excess of \$2.273 billion.<sup>91</sup>

EGSI sought judicial review of the PUC's final order in Docket 7195 and concurrently filed a new contested case ("Docket 8702") to address the \$1.453 billion not adjudicated in Docket 7195. In response, the Office of Public Utility Counsel ("OPUC") and twelve municipalities sued the PUC for a declaratory judgment that the PUC was not authorized to reconsider in a separate contested case the prudence of the \$1.453 billion expenditure deferred in Docket 7195. The OPUC and the twelve municipalities requested a permanent injunction restraining the PUC from conducting any further proceedings addressing the prudence of the deferral in Docket 7195. The district court held that *res judicata* and collateral estoppel barred the PUC from reconsidering the deferred costs and enjoined the PUC from proceeding with Docket 8702. On appeal, the court of appeals reversed this decision and allowed Docket 8702 to proceed.<sup>92</sup>

---

88. *Id.* at 210-11.

89. *Id.* at 211 (emphasis in original).

90. *Id.*

91. *Id.*

92. See *Pub. Util. Comm'n v. Coalition of Cities for Affordable Util. Rates*, 777 S.W.2d 814 (Tex. App.—Austin 1989), *rev'd*, 798 S.W.2d 560 (Tex. 1990).

The Texas Supreme Court reversed that decision, stating "the PUC was powerless to defer its decision to a future proceeding,"<sup>93</sup> and the appeal in Docket 7195 proceeded in district court where the PUC's final order was reversed and the rate case was remanded to the PUC.

On remand, the PUC determined that the remaining portions of the order in Docket 7195 "appeared to hold that [Entergy] had failed to meet its burden" and the \$1.453 billion was properly excluded.<sup>94</sup> Entergy appealed this order, and the district court reversed the PUC order. On appeal, the district court ruling was reversed, and the PUC order disallowing the \$1.453 billion was approved.<sup>95</sup> The Texas Supreme Court again reversed and stated that the PUC could decide whether to entertain further evidence or resolve the case on the evidence previously presented.<sup>96</sup>

The PUC opened Docket 17899 and decided to base its decision on the then-existing record and asked the parties to brief the case again. EGSI agreed to this approach. In its final order in Docket 17899, the PUC excluded the \$1.453 billion from EGSI's cost of service. EGSI then sought judicial review of the order in district court, which affirmed the order.<sup>97</sup> *Entergy Gulf States, Inc. v. Public Utility Commission* is the appeal of the district court's ruling brought by EGSI.

Entergy first argued that the PUC disregarded the Texas Supreme Court's opinion in *Gulf States Utilities* and the law of the case doctrine, which "provides that questions of law decided on appeal to a court of last resort will govern the case throughout its subsequent stages."<sup>98</sup> EGSI maintained that "[a]s a matter of law . . . the Supreme Court decided that [Entergy] had presented a significant amount of evidence supporting the prudence of its entire investment, and that a total disallowance was not supported by the record."<sup>99</sup> Specifically, EGSI relied on the following language in the Texas Supreme Court's opinion: "There was extensive evidence supporting inclusion of all [Entergy's] costs in its rate base and extensive contrary evidence that most of these costs should be excluded."<sup>100</sup> EGSI's interpretation of this language was that the supreme court recognized that EGSI "presented sufficient evidence to establish its prima facie case."<sup>101</sup> The district court disagreed, interpreting the supreme court's statement as a comment on the quantity and not the quality of the evidence introduced. The court discussed the fact that nowhere in the supreme court's opinion did it discuss whether EGSI has estab-

---

93. *Coalition of Cities*, 798 S.W.2d at 564-65.

94. *Id.*

95. *See Gulf States Utils. Co. v. Coalition of Cities for Affordable Util. Rates*, 883 S.W.2d 739 (Tex. App.—Austin 1994), *rev'd*, 947 S.W.2d 887 (Tex. 1997).

96. *Gulf States Utils.*, 947 S.W.2d at 892.

97. *Id.*

98. *Entergy Gulf States, Inc. v. Pub. Util. Comm'n*, 112 S.W.3d 208, 213 (Tex. App.—Austin 2003, *pet. filed* (citing *Hudson v. Wakefield*, 711 S.W.2d 628, 630 (Tex.1986))).

99. *Id.*

100. *Id.* (quoting *Gulf States Util.*, 947 S.W.2d at 888).

101. *Id.*

lished a prima facie case or met its burden of substantial evidence. The court found that the law of the case doctrine was inapplicable because the supreme court did not comment on the weight of EGSI's evidence. EGSI's first issue on appeal was overruled.<sup>102</sup>

EGSI next contended that the PUC erred in ruling that EGSI "had not established its prima facie case of prudence for inclusion of the \$1.453 billion in the rate base."<sup>103</sup> Utilities bear the burden of proving that rate changes are just and reasonable.<sup>104</sup> Under PUC procedure, the utility may shift this burden by establishing a prima facie case of prudence in its rate change. The PUC's conclusion that EGSI did not establish a prima facie case of prudence was based on its repeated review of the entire record. The court held that based on this review, the PUC correctly ruled that EGSI failed in its statutory burden of proof. Further, the court found that the findings of fact and conclusions of law included in the PUC's order were a clear indication that EGSI received a "straightforward decision" on the PUC's determination that the \$1.453 billion would not be included in EGSI's rate base.<sup>105</sup>

EGSI's third issue on appeal was that the PUC's order was not supported by substantial evidence. Specifically, EGSI argued that the following actions were not supported by substantial evidence:

- (1) the PUC failed to find any prudent costs associated with the schedule extension;
- (2) the [PUC failed] to allow recovery of the full financing costs associated with the River Bend investment that it found prudent;
- (3) the disallowance is contrary to undisputed expert testimony and has no reasonable basis in the record as a whole; and
- (4) the record as a whole demonstrates concurrence of the expert witnesses in the prudence of certain costs in excess of the adjusted DCE.<sup>106</sup>

The court's standard of review for a substantial evidence claim is whether "the evidence as a whole is such that reasonable minds could have reached the conclusion the agency must have reached in order to take the disputed action."<sup>107</sup> Upon a review of the evidence, the court held that there was substantial evidence to support the PUC's decision on these issues.

EGSI also argued that it elected not to oppose the PUC's decision not to accept a cost-reconciliation study as evidence in Docket 17899, based on an earlier PUC ruling "that a cost-reconciliation study was not a nec-

---

102. The law of the case doctrine "does not necessarily apply if the issues and facts are not substantially the same in a subsequent trial," and the use of the doctrine should be "left to the discretion of the court and determined on a case-by-case basis." *Id.*

103. *Id.* at 214.

104. TEX. UTIL. CODE ANN. § 36.006 (Vernon 1998).

105. *Entergy Gulf States*, 112 S.W.2d at 218.

106. *Id.*

107. *Id.* (quoting *City of El Paso v. Pub. Util. Comm'n*, 883 S.W.2d 179, 186 (Tex. 1994)).



essary element of a prima facie case.”<sup>108</sup> EGSI claimed that it could have submitted its cost-reconciliation study in response to the PUC’s assertion in its order in Docket 17899 that EGSI failed to “present any credible reconciliation of plant costs with specific causes.”<sup>109</sup> The court, however, found that EGSI supported the PUC’s decision not to take additional evidence and had been afforded opportunities to submit additional evidence and had declined to do so. The court found that EGSI’s argument that a later PUC decision rendered the cost-reconciliation study unnecessary obscured the fact that EGSI had ample opportunity to fully develop the record.<sup>110</sup>

Finally, the court overruled EGSI’s claim that the PUC erroneously adjusted rates to include EGSI’s payments to repurchase River Bend from its project partner and that the PUC denied recovery of EGSI’s payments to its project partner in proportion to the amount of River Bend investment to which it denied recovery. The court based its decision on its earlier approval of the PUC’s determination that any costs above the adjusted DCE were imprudent, which made recalculation of “flow through” costs unnecessary.<sup>111</sup>

### 3. *Transmission and Distribution Rates*

*City of Abilene v. Public Utility Commission*<sup>112</sup> was an appeal by the cities of Abilene, San Angelo, and Vernon (the “Cities”) of a PUC order approving West Texas Utilities Company’s (“WTU”) application for approval of unbundled cost of service rates.<sup>113</sup> The Cities opposed a provision of the order that imposed “an eighty percent demand ratchet for transmission and distribution rates on municipal water pumping customers.”<sup>114</sup>

As part of deregulation, the PUC continued to regulate transmission and distribution rates, and utilities submitted applications for approval of unbundled costs of service. The PUC held a generic proceeding to identify the transmission and distribution rate issues common to all applicants “and issued an interim order establishing customer classifications and rate designs.”<sup>115</sup> As a part of the interim order, the PUC imposed “an eighty percent demand ratchet on transmission and distribution rates for customers with electric meters that tracked demand.”<sup>116</sup> Under the eighty percent demand ratchet, the utility bases the customer’s transmis-

---

108. *Id.* at 220; see Tex. Pub. Util. Comm’n, *Application of Tex. Utils. Elec. Co. for Authority to Change Rates*, Docket No. 9300, 17 TEX. P.U.C. BULL. 2057 (September 27, 1991).

109. *Emergy Gulf States*, 112 S.W.3d at 220.

110. *Id.* at 221.

111. *Id.*

112. *City of Abilene v. Pub. Util. Comm’n*, No. 03-02-00569-CV, 2003 WL 549297 (Tex. App.—Austin Feb. 27, 2003, pet. denied).

113. *Id.* at \*1.

114. *Id.*

115. *Id.*

116. *Id.* at \*1 n.3.

sion and distribution billing rate on the greater of current monthly demand or eighty percent of the customer's monthly demand for the preceding eleven months.<sup>117</sup> The interim order also exempted seasonal agricultural customers, such as cotton ginnerers, from the demand ratchet. The basis for the exemption was that cotton ginnerers operate for only sixty to ninety days annually and use minimal electricity during the rest of the year.<sup>118</sup>

In the generic proceeding, the PUC denied all other applications for the exemption from the demand ratchet. The interim order stated that the PUC

would consider exemptions to the generic rate design "only if necessary to address extraordinary impacts on the ability of customers to obtain service from a competitive provider due to the restrictions on the price to beat (i.e., 'headroom' concerns)." The order went on to state that "because the transmission and distribution rates . . . represent a relatively small proportion of an end-use customer's bill, the design of such rates shall be amended only in the case of exceptional headroom concerns. Such headroom concerns should not automatically mandate the granting of an exception to the generic rate design."<sup>119</sup>

"'Headroom' refers to the margin between the price to beat and the new retailer's costs of providing electricity."<sup>120</sup>

The Cities sought an exemption from the demand ratchet in WTU's individual ratemaking proceeding. The Cities reasoned that municipal water pumping customers were entitled to the exemption because their variable electrical demand was similar to that of the cotton ginnerers. Imposing a demand ratchet on this variable demand would cause lower "headroom" and create a disadvantage for the municipal water pumping customers in seeking competitive electric rates. However, the PUC ruled that municipal water pumping customers were not included in the exemption because the expansion of the exemption "is not warranted on the basis of extraordinary headroom concerns."<sup>121</sup>

The Cities sought review of the WTU order in district court, which upheld the order. The Cities appealed the district court judgment, arguing that the PUC's unequal rate treatment of cotton ginnerers and municipal water pumping customers was unreasonable discrimination in ratemaking and a violation of the PURA Section 36.003(c).<sup>122</sup> They further con-

---

117. *Id.*

118. *Id.* at \*1.

119. *Id.* (alteration in original).

120. *Id.* at \*1 n.5.

121. *Id.* at \*2.

122. *Id.* (citing TEX. UTIL. CODE ANN. § 36.003(c) (Vernon 1998)). "An electric utility may not (1) grant an unreasonable preference or advantage concerning rates to a person in a classification; (2) subject a person in a classification to an unreasonable prejudice or disadvantage concerning rates; or (3) establish or maintain an unreasonable difference concerning rates between localities or between classes of service." TEX. UTIL. CODE ANN. § 36.003(c).

tended that the PUC acted arbitrarily and capriciously by applying one standard to cotton ginners and a “‘different, vague standard’ to municipal water pumping customers.”<sup>123</sup>

The PURA gives the PUC the authority to set transmission and distribution rates. Section 36.003(c) provides that a utility may not grant an “unreasonable preference or advantage concerning rates” or “subject a person in a classification to an unreasonable prejudice or disadvantage concerning rates.”<sup>124</sup> In some circumstances, differentiation in treatment between customers is warranted, and such “unequal treatment neither violates PURA nor invalidates an agency action.”<sup>125</sup> The PUC “must base its disparate treatment on substantial and reasonable differences between the customers.”<sup>126</sup> “Factors for distinctions between customers include quantity of service received, different characteristics of service, time of use, ‘or any other matter which presents a substantial difference as a ground of distinction.’”<sup>127</sup>

The Cities believed that the municipal water pumping customers were situated similarly to the cotton ginners and that, based upon WTU’s data on electrical demands and headroom, the municipal water pumping customers deserved the same exemption to the demand ratchet.<sup>128</sup> They further contended that the PUC’s unequal rate treatment was unjustified because the PUC failed to identify substantial differences between the municipal water pumping customers and the cotton ginners.

The court disagreed with the Cities’ position and found evidence of a “substantial and reasonable difference” between the municipal water pumping customers and the cotton ginners which justified the unequal rate treatment.<sup>129</sup> The cotton ginners use large amounts of electricity for sixty to ninety days per year, with little or no use during the remainder of the year. The demand ratchet exemption for the cotton ginners was based on “highly variable usage patterns within the year” which were “unique.”<sup>130</sup> The evidence presented by the Cities showed that their demand varied “significantly from month to month” and the Cities would experience negative headroom as a result of the demand ratchet.<sup>131</sup> The court held that the PUC’s determination that the Cities’ demand was not as variable as the cotton ginners’ demand qualified as a “substantial and reasonable” difference, justifying the disparate rate treatment, and that the PUC’s decision not to include municipal water pumping customers in the demand ratchet exemption “was not an ‘unreasonable preference or advantage concerning rates’ to the cotton ginners.”<sup>132</sup>

---

123. *City of Abilene*, 2003 WL 549297, at \*2.

124. TEX. UTIL. CODE ANN. § 36.003(c).

125. *City of Abilene*, 2003 WL 549297, at \*3.

126. *Id.* at \*4.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.* at \*5.

131. *Id.*

132. *Id.* (quoting TEX. UTIL. CODE ANN. § 36.003).

#### 4. Annual Reports

In preparation for deregulation, the PURA was amended in 1999 to set all electric utilities' interim rates until January 1, 2002. The amended provisions also included a requirement that utilities file annual reports with the PUC for each of the calendar years 1999, 2000, and 2001.<sup>133</sup> The utilities were required to submit the annual reports in a format prescribed by the PUC.<sup>134</sup> The purpose of these reports was to identify any excess or "positive difference" of "adjusted annual revenues" over and above the utility's "annual costs."<sup>135</sup> The PURA mandates that the excess revenue be applied to either stranded cost recovery efforts, customer refunds, improvements on transmission and distribution facilities, or additional pollution-control equipment.<sup>136</sup>

*American Electric Power Co. v. Public Utility Commission*<sup>137</sup> held that utilities are not required to subtract from invested capital any portion of their accumulated deferred income tax ("ADIT") accounts attributable to under-recovered fuel costs. American Electric Power ("AEP") and TXU Electric Company ("TXU") challenged a PUC order requiring them to revise their annual reports to include a deduction from their invested capital in the amount of their ADIT accounts attributable to fuel-cost under-recovery.<sup>138</sup>

The 1999 amendments to the PURA outline the calculations and adjustments to be used in the annual report for the purpose of identifying any excess of annual revenue over annual costs.<sup>139</sup> Revenues for the calendar year are adjusted by deducting revenues derived from specified sources, including "sums received by the utility as a result of any [PUC] adjustment of the reporting utility's fixed-fuel factor and a subsequent reconciliation as contemplated" by Section 36.203 of the PURA.<sup>140</sup> Costs for the calendar year are adjusted in order to arrive at the utility's annual costs. "Among these [adjustments] are costs resulting from [PUC] adjustments of the utility's fixed-fuel cost and a subsequent reconciliation."<sup>141</sup>

There are several key concepts germane to the controversy in this case. First among them is the term "invested capital." "[T]he 1999 amendments included a provision for fixing the utility's return on invested capital" in the annual report.<sup>142</sup> "Invested capital" is not a defined term

---

133. TEX. UTIL. CODE ANN. § 39.257(a) (Vernon Supp. 2004).

134. *Id.*

135. *Id.* § 39.257(b).

136. *See id.* §§ 39.254, .255. A utility is benefited by maximizing its annual costs while minimizing its calendar-year revenues, because in doing so it reduces the amount of any excess that must be applied to these items while increasing the amount retained by the utility for operating and other costs of service.

137. *Am. Elec. Power Co. v. Pub. Util. Comm'n*, 123 S.W.3d 33 (Tex. App.—Austin 2003, no pet.).

138. *Id.* at 35.

139. *Id.* at 35-36.

140. TEX. UTIL. CODE ANN. § 39.257(b) (Vernon Supp. 2004).

141. *Id.* § 39.258.

142. *Id.* § 39.258(7).

under the PURA, but its components are described broadly thereunder as "property used by and useful to the utility in providing service," which is appraised based on original costs less depreciation.<sup>143</sup> The PURA further states "[t]he definition and identification of invested capital . . . shall be treated in accordance with generally accepted accounting principles as modified by regulatory accounting rules generally applicable to utilities."<sup>144</sup>

Section 39.259 of the PURA provides that both "regulatory assets and deferred federal income taxes shall be updated each year" before calculating the utility's invested capital for purposes of the annual report.<sup>145</sup> "Regulatory assets' enlarge invested capital while 'deferred federal income taxes' reduce invested capital."<sup>146</sup> Thus, a utility's annual costs increase and decrease with a corresponding change in invested capital.<sup>147</sup>

An understanding of the role of deferred income taxes in this case is also essential. "A utility's under-recovery of fuel costs may create other accounts on its books, including a record of its expected liability for federal income tax on the revenues it anticipates receiving at some future date when the PUC authorizes the inclusion of a surcharge in customer bills." Until the "payment of the surcharges is actually received, the utility's federal income-tax liability is said to be 'deferred.'"<sup>148</sup> While the liability remains deferred, it may be included in an ADIT account.<sup>149</sup>

"In their annual reports for calendar year 2000, [AEP and TXU] excluded from their invested capital the balance in both their under-recovered fuel-cost account and the corresponding part of their ADIT account."<sup>150</sup> The PUC ordered the utilities "to revise their annual reports to include in their invested-capital calculation a deduction equal to the amount of ADIT attributable to a future fuel-factor adjustment and reconciliation."<sup>151</sup> The district court affirmed the PUC's order.<sup>152</sup>

The PUC argued that ADIT should be included as a deduction from invested capital on two grounds: (1) the language in Section 39.259(a) of PURA that calls for an annual update of deferred federal income taxes indicates a legislative intent that the total amount of a utility's ADIT account must be included as an offset to invested capital, including that part of ADIT attributable to a future fuel-cost adjustment and reconciliation; and, (2) that part of the ADIT account attributable to fuel-cost under-recovery "is not a fuel cost or revenue recovered in the fuel-factor/fuel reconciliation process [but] is, instead, cash realized from the infusion of

---

143. TEX. UTIL. CODE ANN. § 36.053(a) (Vernon 1998).

144. *Id.* § 39.260(a).

145. *Id.* § 39.259(a).

146. *American Elec. Power Co.*, 123 S.W.3d at 37.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* at 38.

cost-free capital as a result of the deferral of income tax expense.”<sup>153</sup>

The court rejected both of these arguments. As to the first, the court explained that Section 39.259(a) of PURA sets forth no exception from the required inclusion of “regulatory assets” in the annual update.<sup>154</sup> The PUC properly excluded from regulatory assets the balance in the under-recovered fuel-cost account because the exclusion was necessary to comply with the required adjustment for annual revenues under the fuel cost recovery provisions of Section 36.203 of the PURA.<sup>155</sup>

Regarding the PUC’s second argument, the court disagreed with the PUC’s characterization of an under-recovered fuel-cost item in the ADIT account as “cash realized from the infusion of cost-free capital as a result of the deferral of income tax expense.”<sup>156</sup> The portion of a utility’s ADIT account attributable to fuel-cost under-recoveries represents merely a record of a prospective liability for federal income tax, which will not actually arise until the utility’s customers pay their bills containing a surcharge authorized by the PUC following a fuel-factor adjustment and fuel-cost reconciliation. The court determined that the recording of deferred income taxes does not produce cost-free capital because the funds do not become available until the customers payments are actually collected. The PUC’s order requiring utilities “to include in their invested-capital calculation a deduction . . . in the amount of their ADIT account attributable to fuel-cost under-recovery” was invalid and was therefore reversed.<sup>157</sup>

## 5. Consumer Protection

Under deregulation, consumers are exposed to dangers that the regulated system was designed to protect against, such as potential market-price manipulation by incumbent utilities and affiliated REPs, decisions by REPs not to serve given areas or customer classes, and poor treatment of consumers on billing and service matters. The PUC has adopted a system for protecting consumers in circumstances where REPs are unwilling to provide service to a particular area or class of customer. The PURA requires that a “provider of last resort” (“POLR”) be designated for each distribution area in order to ensure that all consumers will be offered electricity service. Each customer is entitled to service from the POLR under a standard service package determined by the PUC.<sup>158</sup> The POLR is to be an REP chosen by a competitive mechanism or designated by the PUC.<sup>159</sup>

---

153. *Id.* (alteration in original).

154. *Id.*

155. *Id.*

156. *Id.* (quoting PUC’s brief).

157. *Id.* at 39.

158. TEX. UTIL. CODE ANN. § 39.101(b)(4) (Vernon Supp. 2004).

159. *Id.* § 39.106(a), (e).

In *Office of Public Utility Counsel v. Public Utility Commission*,<sup>160</sup> the Office of Public Utility Counsel ("OPUC") challenged two amended rules as being outside the scope of the PUC's authority under the PURA.<sup>161</sup> The first rule concerned the authority of competitive REPs to request disconnection of customer electric service, and the second rule governed the rate to be charged by POLRs.

The original disconnection rule promulgated by the PUC "allowed only POLRs to request disconnection of customer service when customers failed to pay" their bills<sup>162</sup> because the PUC was concerned that the deregulation process would disrupt electricity service.<sup>163</sup> The original disconnection rule required REPs that no longer wished to serve certain customers to transfer those customers directly to the POLR without any interruption in service, which meant that non-paying customers would automatically be transferred to the POLR before their service could be disconnected.<sup>164</sup> In the amended disconnection rule, the PUC adopted a provision to the effect that, after 2004, the competitive REPs would be able to request disconnection of non-paying customers without first transferring them to the POLR.<sup>165</sup> "The [PUC] determined that, as opposed to customers who received no electricity service because of market forces, customers who were delinquent in paying their bills would not be entitled to be automatically transferred to POLR service."<sup>166</sup> Under the amended disconnection rule, after September 4, 2002, non-paying customers are to be transferred to the affiliated REP and charged the applicable price-to-beat, and then, after October 2004, all REPs will be allowed to request disconnection of non-paying customers.<sup>167</sup>

OPUC's second challenge was to the PUC's original POLR rule that governed POLR selection, using a competitive bidding process to set the POLR rate with the default rate set at the price to beat.<sup>168</sup> If no REPs participated in the competitive-bidding process, then the original POLR rule provided that the PUC would determine the POLR and set the POLR's rate at the price to beat.<sup>169</sup> However, the PUC had a difficult time finding utilities willing to serve as POLRs under the original POLR rule, so the agency amended the POLR rule to provide that the POLR

---

160. *Office of Pub. Util. Counsel v. Pub. Util. Comm'n*, 104 S.W.3d 225 (Tex. App.—Austin 2003, no pet.).

161. *Id.* at 227.

162. *Id.* at 230. POLRs and REPs must submit requests to the transmission and distribution utility, which is the entity that actually disconnects the customer's electric service. *Id.* at 230 n.2.

163. *Id.* at 230 (referencing 27 Tex. Reg. 8428 (2002) (to be codified at 16 TEX. ADMIN. CODE § 25.483) (the "Original Disconnection Rule") and 27 Tex. Reg. 8428, 8428-8430 (2002) (to be codified at 16 TEX. ADMIN. CODE § 25.483) (the "Amended Disconnection Rule")).

164. *Id.*

165. *Id.* (referencing 27 Tex. Reg. 8474).

166. *Id.*

167. *Id.* (citing Disconnection Rule § 25.483(b)).

168. *Id.* (referencing 25 Tex. Reg. 10899, 10916 (2000) (repealed by 27 Tex. Reg. 8428 (2002)) (to be codified at 16 TEX. ADMIN. CODE § 25.43)).

169. *Id.* at 230-31.

rate would be set at or above the price to beat, with a ceiling of twenty-five percent greater than the price to beat.<sup>170</sup> The amended POLR rule treats affiliated REP that serve as a POLR differently from other REPs bidding to serve as a POLR. Affiliated REPs may only serve as POLRs if they bid to provide POLR service at the lowest price, the price to beat.<sup>171</sup> The amended POLR rule provides that a POLR is to be selected either by a competitive bidding process or, if there are no bidders, by lottery. If the POLR is selected by lottery, the rate charged to residential and small commercial customers is set at the highest allowable rate, twenty-five percent greater than the price to beat.<sup>172</sup> The PUC is given the authority to adjust the POLR rate “for good cause to ensure that it is sufficient to recover the POLR’s cost of providing service.”<sup>173</sup>

OPUC brought a direct appeal to challenge the validity of the amended disconnection and POLR rules, arguing that PURA “creates an affirmative right in consumers to be offered (1) POLR service ‘without interruption’ and (2) electric service at or under the applicable price to beat.”<sup>174</sup> OPUC contended that the PUC’s disconnection and POLR “rules may only be adopted in order to further and enforce the consumer-protections” created in Chapter 39 of the PURA, and any rule that is contrary to consumers’ specific rights to POLR disconnection and the price-to-beat exceeds the statutory authority of the PUC.<sup>175</sup>

The PUC’s response to OPUC’s contentions was that chapter 39 of PURA does not create an affirmative consumer right to have service transferred to the POLR in cases of non-payment nor does it create the price to beat as a limit on rates POLRs may charge. According to the PUC, the amended rules violated no specific requirements of PURA and did not impermissibly interfere with its statutory intent.<sup>176</sup>

Section 39.106 of PURA outlines the POLR’s duty to consumers in its service area and includes the following provision: (g) In the event that a retail electric provider fails to serve any or all of its customers, the provider of last resort shall offer that customer the standard retail service package for that customer class *with no interruption of service to any customer*.<sup>177</sup> OPUC argued that this provision prevented the PUC “from adopting a rule that allows for any potential gap in service between the time a REP decides to stop providing electricity to a customer and the time that the customer begins to receive POLR electricity service.”<sup>178</sup> OPUC maintained that, under the amended disconnection rule, when a customer is disconnected upon request of the customer’s REP, then the

---

170. *Id.* at 231 (referencing 27 Tex. Reg. 8428, 8463-65 (2002) (to be codified at 16 TEX. ADMIN. CODE § 25.43) (the “Amended POLR Rule”).

171. *Id.* (citing Amended POLR Rule § 25.43(h)(2)).

172. *Id.* (citing Amended POLR Rule § 25.43(k)(4)).

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.* at 233 (citing TEX. UTIL. CODE ANN. § 39.106(g) (Vernon Supp. 2004)).

178. *Id.*



customer will have to apply to the POLR for service, which added a non-statutory regulatory requirement in addition to the “without interruption” standard. OPUC argued that the PUC adopted a standard that conflicts with the overall purpose and objective of the PURA.<sup>179</sup>

The PUC argued, and the court agreed, that Section 39.106(g) of PURA, at most, “requires the POLR to *offer* service to disconnected customers without interruption, not to *guarantee* continuous electricity service during any conflict with the REP.”<sup>180</sup> The court held that the amended disconnection rule did not violate Section 39.106 because the POLRs are in a position to offer consumers electric service without interruption and the same consumer protections of PURA will apply to disconnection of service, regardless of whether the POLR or the REP disconnects the customer.<sup>181</sup>

OPUC also argued that any rule allowing the POLR rate to be set above the price to beat violates the PURA. The PUC’s position was that the price to beat applies only to affiliated REPs and is not a general consumer protection.<sup>182</sup> The court upheld the rule, explaining that PURA requires only affiliated REPs to charge the price to beat during the transition period and that the amended POLR rate rule is consistent with this provision because it requires affiliated REPs that serve as POLRs to charge the price to beat.<sup>183</sup>

Additionally, OPUC argued that the disconnection rule was not adopted in conformity with the Administrative Procedure Act’s reasoned justification requirement because the PUC did not expressly address OPUC’s argument concerning the construction of Sections 39.101(b)(4) and 39.106 of PURA.<sup>184</sup> In regard to this claim, the court found that, although the PUC did not explicitly address OPUC’s comment, the order adequately explains the PUC’s interpretation of the relevant provisions of PURA and offers a rational justification for its decision to change the consumer protection rules. The court acknowledged that OPUC’s challenge might raise a technical defect in adopting the order. However, absent a showing of prejudice to a given right or privilege, a technical defect is insufficient to invalidate an otherwise valid rule.<sup>185</sup>

## 6. Wholesale Transmission Rules

In 1995, the Texas Legislature amended PURA to promote competition in the wholesale electricity market.<sup>186</sup> “PURA 95” required electric

---

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.* at 235-36.

183. *Id.* at 236.

184. *Id.* at 234.

185. *Id.* at 235 (citing TEX. GOV’T CODE ANN. § 2001.035(d) (Vernon 2000)).

186. Pub. Util. Comm’n v. City Pub. Serv. Bd. of San Antonio, 109 S.W.3d 130, 132 (Tex. App.—Austin 2003, no pet.) (referencing Act of May 28, 1995, 74th Leg., R.S., ch. 765, § 2.01(a), 1995 Tex. Gen. Laws 3972, 3988-89 (codified at TEX. UTIL. CODE ANN. § 31.001(c))).

utilities to “provide open access to their transmission facilities.”<sup>187</sup> Each utility was required to provide transmission service at rates and terms comparable to what it costs the utility to operate its own system. Therefore, the utilities “had to ‘unbundle’ the costs associated with their transmission facilities from the costs associated with their generation and distribution facilities.”<sup>188</sup> PURA 95 required the PUC to adopt wholesale transmission service rules and mandated that utilities file tariffs in compliance with those rules.<sup>189</sup>

“Texas utilities have voluntarily interconnected their regional transmission networks to form a single grid called the Electric Reliability Council of Texas (ERCOT). When wholesale power is sold, it is transported over this ERCOT grid.”<sup>190</sup> The PUC adopted rules in 1996 requiring each ERCOT utility to pay every other ERCOT utility a “facilities charge” for transmission service, which is comprised of an “impact fee” and an “access fee.”<sup>191</sup> The “impact fee made up thirty percent of the facilities charge and was calculated based upon the distance traveled by the electricity in the transmission customer’s wholesale transactions.”<sup>192</sup> The access fee makes up the remaining seventy percent of the facilities charge and was based on the transmission customer’s percentage of use of the ERCOT grid. The access fee is determined by applying the transmission customer’s percentage of the peak-load quantity of electricity channeled through the ERCOT grid to the transmission cost of service (“TCOS”) for the entire grid.<sup>193</sup>

In order to set transmission rates, the PUC commenced individual proceedings to determine the TCOS for each ERCOT utility. It also initiated a companion generic proceeding to resolve common issues and to set transmission rates using the costs determined in the individual cases.<sup>194</sup> During the proceedings for individual utilities, the City Public Service Board of San Antonio (“San Antonio”) filed a declaratory judgment action claiming that the PUC had exceeded its statutory authority in promulgating the wholesale transmission rules. The Texas Supreme Court ruled that PURA 95 gave the PUC oversight of wholesale transmission service but not the authority to set initial rates for municipally-owned utilities such as San Antonio.<sup>195</sup> The supreme court further stated that the PUC “does not have the power to set wholesale transmission rates initially, but once a dispute arises, it can either refer the parties to alternative dispute resolution or it may set a reasonable rate to resolve

---

187. *Id.*

188. *Id.*

189. *Id.* a 133 (referencing TEX. UTIL. CODE ANN. §§ 35.006(a), .007(a) (Vernon 1998)).

190. *Id.* at 132.

191. *Id.* at 133 (referencing 21 Tex. Reg. 1397 (1996) (to be codified at 16 TEX. ADMIN. CODE § 23.67) (“Rule 23.67”) and 21 Tex. Reg. 3343 (1996) (to be codified at 16 TEX. ADMIN. CODE § 23.70) (“Rule 23.70”)).

192. *Id.* (citing Rule 23.67(g)(1) and 23.70(o)).

193. *Id.* (citing Rule 23.67(g)).

194. *Id.* at 134.

195. City Pub. Serv. Bd. v. Pub. Util. Comm’n, 53 S.W.3d 310, 323-24 (Tex. 2001).

the dispute.”<sup>196</sup>

During the appeal of San Antonio’s declaratory judgment action, San Antonio also sought judicial review of its TCOS as determined by the PUC following the contested case proceeding. San Antonio believed that the PUC had set a TCOS number that was too low. Initially, the district court upheld the PUC’s order regarding San Antonio’s TCOS determination. However, following the Texas Supreme Court’s decision on the transmission rules, the district court conducted a new hearing and vacated the PUC’s order on San Antonio’s TCOS on the basis that it exceeded the PUC’s statutory authority.<sup>197</sup>

In *Public Utility Commission v. City Public Service Board*,<sup>198</sup> the PUC appealed the district court’s ruling on the PUC determination of San Antonio’s TCOS. The PUC argued that although the TCOS proceedings were initially conducted as part of a rate-setting scheme, the PUC has other duties that empower it to determine the TCOS of individual utilities. San Antonio argued, however, that determining a utility’s TCOS is “tantamount to setting its transmission rates.”<sup>199</sup>

The court found that because the PUC admitted that it initiated the TCOS proceeding for the purpose of setting rates, which was unquestionably beyond the scope of its authority, the PUC’s final order on San Antonio’s TCOS must be reversed unless the PUC had some independent basis of authority to initiate such a case.<sup>200</sup> The PUC maintained that such authority existed in its responsibilities related to the oversight of the transmission-service market, and argued that it could not determine whether San Antonio’s rates were reasonable “without first knowing the costs associated with its provision of transmission service.”<sup>201</sup> The agency also contended that its authority to oversee San Antonio’s unbundling of costs encompasses the authority to determine San Antonio’s TCOS. Rejecting these arguments, the court stated that allowing the PUC to establish an individual municipal utility’s TCOS, separate and apart from its role of resolving a dispute, and to use that authority to check reasonableness or conduct its other oversight functions, “bears too close a nexus to actual rate-setting to withstand scrutiny.”<sup>202</sup> The court held that an initial determination of a municipal utility’s TCOS is tantamount to an initial determination of its wholesale transmission rates, and reversed the PUC’s order.<sup>203</sup>

---

196. *Id.* at 320.

197. *San Antonio*, 109 S.W.3d at 132.

198. *Id.*

199. *Id.* at 136.

200. *Id.*

201. *Id.*

202. *Id.* at 137.

203. *Id.*

## 7. CCN Approval

In order to construct a transmission line, an electric utility must first obtain a certificate of convenience and necessity (“CCN”) from the PUC.<sup>204</sup> *Hammack v. Public Utility Commission*<sup>205</sup> upheld a PUC decision to grant a CCN based on considerations of the needs of the emerging statewide competitive wholesale market for electricity.<sup>206</sup>

Central Power and Light Company (“Central Power”) filed an application at the PUC for a CCN to construct a fifty-three-mile long, high-voltage transmission line. Several landowners contested this application. The PUC referred the contested case to the State Office of Administrative Hearings (“SOAH”), where the Administrative Law Judge (“ALJ”) issued a proposal for decision (“PFD”) recommending denial of the application. The basis for SOAH’s recommendation was “that there was insufficient evidence demonstrating a public need for the proposed line.”<sup>207</sup> SOAH’s PFD supported the proposed route for the transmission line. The PUC conducted its own review of the evidence, however, and approved the CCN application, stating in its final order that it found “there was a public need for the line, that existing service was inadequate, and that granting the CCN would result in probable improvement of service or lower costs to consumers.”<sup>208</sup>

PURA and PUC rules provide that the PUC may grant a CCN only if it finds that the CCN is necessary for the service, accommodation, convenience, or safety of the public.<sup>209</sup> The landowners argued on appeal of the PUC’s order that the PUC applied a new legal standard of public need. The landowners contended that the public need standard employed by the PUC was inconsistent with the plain meaning of PURA and in excess of the PUC’s statutory authority, resulting in due process violations.<sup>210</sup> The landowners referred to specific language in the PUC’s order where the agency stated, “a broader view should be taken when evaluating the issue of need,” and argued that the PUC’s justification of its approval of the application was based on a global assertion of the “needs of the interconnected statewide transmission systems.”<sup>211</sup> The landowners claimed that the PUC could consider only the “adequacy of existing service” and “the effect of granting the certificate on the recipient of the certificate and any electric utility serving in the proximate area.”<sup>212</sup>

---

204. TEX. UTIL. CODE ANN. § 37.051 (Vernon 1998).

205. *Hammack v. Pub. Util. Comm’n*, No. 03-02-00232-CV, 2003 WL 22409500 (Tex. App.—Austin Oct. 23, 2003, no pet. h.).

206. *Id.* at \*1.

207. *Id.* at \*2.

208. *Id.*

209. TEX. UTIL. CODE ANN. § 37.056(a) (Vernon 1998).

210. *Hammack*, 2003 WL 22409500, at \*3.

211. *Id.*

212. *Id.* (citing TEX. UTIL. CODE ANN. § 37.056(c) (Vernon 1998)).

In reaching its conclusion that the proposed line was necessary, the PUC made numerous findings of fact based on (1) a report issued in October 1999 by the ERCOT Independent System Operator ("ISO"),<sup>213</sup> which identified a transmission constraints from South Texas to North Texas, into the Rio Grande Valley, and in the Corpus Christi area, and (2) the testimony of an ERCOT representative, which provided that, although construction had begun on a substantial amount of new generation in the Corpus Christi and Lower Rio Grande Valley areas since ERCOT's initial report, the new generation would result in potential export constraints and would not eliminate import constraints during peak usage.<sup>214</sup> The court found that the PUC reasonably interpreted and applied the public-need standard by including consideration of customers and market participants throughout Texas as opposed to only one isolated part of the state. The court held that the PUC had flexibility in applying the public need standard of PURA and that its application of the standard to Central Power's request for a CCN was proper in light of the entire statutory scheme.<sup>215</sup>

The landowners also maintained that there was no substantial evidence to support the PUC's grant of the CCN application. The standard for a substantial evidence review is whether reasonable minds could have reached the agency's conclusion.<sup>216</sup> The court held that the ISO report and the testimony of the ERCOT representative clearly provided a reasonable basis in the record for the PUC's determinations of public need and that the proposed line would result in the probable improvement of service or lowering of costs to consumers.<sup>217</sup>

The landowners argued that the PUC's order concerning the route of the proposed line did not properly consider the statutory criteria and was not supported by substantial evidence. In its review of the proposed route, the PUC considered, among other evidence, a routing study provided by a consulting firm hired by Central Power. The routing study considered twenty-eight different routes and evaluated many of the statutory factors in Section 37.056(c) of PURA, including community values, historical and aesthetic values, parks and recreation areas, and environmental impacts.<sup>218</sup> The landowners claimed that the PUC erred by failing to require Central Power to route the proposed line so that it followed the existing rights of way. The court determined that the PUC was not statutorily required to consider the use of existing rights of way in evalu-

---

213. ERCOT is required to establish an ISO that is responsible for overseeing the transmission system in Texas. TEX. UTIL. CODE ANN. § 39.151 (Vernon Supp. 2004). The ISO's duties include providing an annual report to the PUC identifying existing and potential transmission and distribution constraints, system needs, and making recommendations for meeting those needs. *Id.* § 39.155(b).

214. *Hammack*, 2003 WL 22409500, at \*5.

215. *Id.* at \*7-8.

216. *Id.* at \*8 (citing Texas State Bd. of Dental Exam'rs v. Sizemore, 759 S.W.2d 114, 116 (Tex. 1988)).

217. *Id.* at \*8.

218. *Id.* at \*10.

ating Central Power's proposed route.<sup>219</sup>

The landowners further complained that the PUC's order was not supported by substantial evidence because Central Power did not officially propose alternative routes and because the route studied by Central Power's consultants was not the route approved. The court found that the routing study was substantial evidence that Central Power considered numerous alternative routes and that, given the scope of the routing study, the PUC reasonably concluded that that minor route changes were not significant enough to have been outside the scope of the environmental assessment.<sup>220</sup>

The landowners complained of a number of procedural irregularities. The majority of the complaints were allegations of prohibited *ex parte* communications in the review of Central Power's application. They also claimed violations of the Texas Open Meetings Act and that the trial court erred by sustaining the PUC's claim of privilege regarding certain documents.<sup>221</sup> The court overruled all of the landowners' points of error concerning these procedural irregularities.<sup>222</sup>

### C. NEGLIGENCE

*Victoria Electric Cooperative v. Williams*<sup>223</sup> holds that a utility is not liable for the negligence of its independent contractor hired to construct and maintain electric distribution lines. In this case, an electric cooperative appealed the judgment in a wrongful death action that found the utility "liable for negligence in the transportation of utility poles by its independent contractor."<sup>224</sup>

Victoria Electric is a rural electric cooperative operating under a statutorily authorized franchise granted by the City of Victoria to provide electric service to the city. Victoria Electric entered into a contract with Urban Electrical Services, Inc. to construct and maintain electrical distribution lines. The accident occurred when a motorist struck a utility pole that extended past the end of Urban's trailer. Urban settled with the plaintiffs for \$2 million. The jury found actual damages in the amount of \$5.016 million and assigned responsibility fifty percent to Victoria Electric, twenty-five percent to Urban, and twenty-five percent to the Urban employee driving the truck.<sup>225</sup> After applying the settlement credit, the trial court awarded judgment for the remaining balance to Victoria Electric, imputing Urban's and the driver's negligence to Victoria Electric. The trial court held that: "(1) Victoria Electric retained the right to control Urban's activities; (2) Victoria Electric had a non-delegable duty of

---

219. *Id.*

220. *Id.*

221. *Id.* at \*12.

222. *Id.* at \*13-16.

223. *Victoria Elec. Coop. v. Williams*, 100 S.W.3d 323 (Tex. App.—San Antonio 2003, pet. denied).

224. *Id.* at 325.

225. *Id.*

care under the 'peculiar risk' and 'inherently dangerous activity' exceptions; and (3) Victoria Electric had a non-delegable duty of care under the franchise exception."<sup>226</sup> The franchise exception, found in Section 428 of the Restatement of Torts, provides "that a general contractor carrying on an activity, 'which can be lawfully carried on only under a franchise granted by public authority and which involves an unreasonable risk of harm to others' is liable for negligence of its independent contractors."<sup>227</sup>

The court found that the trial court erred in its holding, and reversed and rendered judgment in favor of Victoria Electric on all claims. In its discussion of the franchise exception, the court declined to hold "that the transportation of utility poles is an activity that can only be carried out under a franchise."<sup>228</sup>

#### D. CONTRACTS

In *Houston Lighting & Power Co. v. City of Wharton*,<sup>229</sup> the defense of laches was held to be unavailable to Houston Lighting & Power Company ("HL&P") in a dispute that involved the correct interpretation of franchise-fee agreements between HL&P and the cities of Wharton, Galveston, and Pasadena (the "Cities").<sup>230</sup>

A regulated utility is entitled to recover from its customers all of its reasonable and necessary operating expenses. Franchise fees are a reasonable and necessary expense and are limited by statute to two percent of the gross receipts from the sale of electricity. A utility may, however, give its consent to be charged a higher franchise fee.

In 1957, HL&P entered into franchise agreements with several cities within its service area. The franchise agreements provided that the cities would grant to HL&P the right to conduct an electrical lighting and power business and to use public streets, roads, and easements to erect poles, lines, towers, and other appurtenances necessary to conduct, distribute, and sell electricity within each city. In return, HL&P would pay a franchise fee to each city of \$500 annually plus "[four percent] of the gross receipts for such year, exclusive of receipts for street lighting, received by [HL&P] from its electrical lighting and power sales for consumption within the corporate limits of the City."<sup>231</sup> Each city passed an ordinance that set out the franchise agreement and provided that the franchise would continue for a term of fifty years beginning January 1,

226. *Id.* at 326.

227. *Id.* at 331 (citing RESTATEMENT (SECOND) OF TORTS § 428 (1977)).

228. *Id.* at 332.

229. *Houston Lighting & Power Co. v. City of Wharton*, 101 S.W.3d 633 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

230. *Id.* at 638-39.

231. *Id.* at 635 (alteration in original).

1958.<sup>232</sup>

In 1957, most of the services rendered to customers by HL&P were included in calculating the cost of electricity and were billed to customers as a portion of the cost of electricity. The franchise fee was not paid on any miscellaneous charges that were not included in the cost of electricity. Over time, additional charges were excluded from the cost of electricity, including wholesale sales to other electric utilities, “wheeling,”<sup>233</sup> customer pay jobs,<sup>234</sup> pole attachment charges, and miscellaneous services. The basis for these exclusions was that the cost of special services should not be borne by the ratepayer, but by the customer who benefited from the service. HL&P “did not pay the franchise fee on any costs that were excluded from the cost of electricity.”<sup>235</sup>

In 1986, HL&P began “factoring” its accounts. Factoring is a process by which a business sells to another business, at a small discount, its right to collect money before the money is paid. [It] reduces the amount of working capital that a business needs by reducing the delay between the time of sale and the receipt of payment.

In 1996, fifty cities in the HL&P service area sued the utility for a declaratory judgment to construe the franchise-fee agreement and for breach of the agreement, fraud, and unjust enrichment. The case was certified as a class action, and the Cities were the class representatives. In 2000, the trial court directed a separate trial on the claims of the Cities and reserved a ruling on HL&P’s motion to decertify the class.<sup>236</sup> The jury found that: (1) HL&P failed to comply with the franchise agreements with respect to the customer pay jobs, miscellaneous charges, and the discount on the factored accounts; (2) HL&P committed fraud against the Cities after the agreements were signed; and (3) HL&P was unjustly enriched by use of the agreements and the unjust enrichment was “committed” with malice. The jury did not find that HL&P had fraudulently induced the Cities to enter the franchise agreements. The jury found that laches applied to the Cities’ claims for all seven requested items of recovery. The issue of attorneys’ fees was not presented to the jury because HL&P stipulated that a reasonable and necessary attorneys’ fees of forty percent of the damages awarded in the case to be awarded to the Cities counsel.<sup>237</sup> The jury awarded actual and punitive damages to each of the Cities for HL&P’s breach of the agreement, fraud, and unjust enrichment.

The trial court “disregarded the fraud and unjust enrichment findings on the basis that the Cities’ claims sounded in contract” and also disre-

---

232. *Id.* Only the cities of Wharton and Galveston entered the agreement in 1957. The City of Pasadena entered the same agreement in 1965 for a period of 50 years beginning November 1, 1965.

233. Wheeling is other utility companies using HL&P’s property.

234. These are special services for which a customer was billed directly.

235. *Id.* at 636.

236. *Id.* at 637.

237. *Id.*



garded the laches finding.<sup>238</sup> In the final judgment, “the trial court awarded the contract damages found by the jury in the amount of \$1,175,193.88, plus attorneys’ fees of \$13,683,181 as [forty percent] of the damages awarded by the jury.”<sup>239</sup>

In its appeal, HL&P challenge[d] the trial court’s award of damages for breach of the agreement and the legal and factual sufficiency of the evidence to support the jury’s findings of breach of the agreement and damages, the trial court’s disregard of the jury’s laches finding, and the award of attorneys’ fees. The Cities appeal[ed] the trial court’s disregard of the jury’s fraud and unjust enrichment findings and the partial summary judgment ruling that sales taxes are not included in HL&P’s gross receipts.<sup>240</sup>

HL&P’s third point of appeal, the trial court’s disregard of the jury’s finding on the affirmative defense of laches, was dispositive of both appeals. Laches would apply “if a city unreasonably delayed asserting its rights and HL&P made a good faith change of position to its detriment as a result of the delay.”<sup>241</sup> The basis for the trial court’s disregard of the laches finding was the legal theory that laches does not bar a claim by a governmental unit when the governmental unit is performing a governmental function.<sup>242</sup>

The Cities contended laches does not apply because (1) their causes of action are subject to statute of limitations and their suit is to enforce a statutory right and (2) the Cities were performing a governmental function. In response to the Cities’ first argument, HL&P asserted that the relevant statute of limitations did not apply to claims by incorporated cities.<sup>243</sup> Section 16.061(a) of the Texas Civil Practices & Remedies Code states “a right of action of . . . an incorporated city or town . . . is not barred” by any statute of limitations.<sup>244</sup> The court held that, because the statute of limitations in Section 16.061(a) does not apply to the Cities’ claim, laches is an appropriate remedy. The court further held that because the Cities did not raise any objection to the payments, nor did they question the payments for well over thirty years, but simply accepted the payments from HL&P, the defense of laches was available.<sup>245</sup>

“The essential elements of laches are (1) unreasonable delay in asserting one’s legal or equitable rights and (2) a good faith change of position by another to his detriment because of the delay.”<sup>246</sup> The court held that “a delay of over [thirty] years is unreasonable as a matter of law”<sup>247</sup> and

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.* at 638.

242. *Id.*

243. *Id.* at 638-39.

244. *Id.* at 639 (citing TEX. CIV. PRAC. & REM. CODE ANN. § 16.061(a) (Vernon Supp. 2003)).

245. *Id.*

246. *Id.*

247. *Id.*

that

HL&P's failure to collect [four percent] of its gross receipts on those revenues challenged by the Cities in this litigation and its inability to collect the disputed fees from the customers whose purchases would have generated the fees are some evidence of a change of position that was detrimental to HL&P because of the delay.<sup>248</sup>

Therefore, the court sustained HL&P's third point of error regarding the jury's finding on the laches defense.

### III. LEGISLATION

#### A. ELECTRIC UTILITY

##### 1. *House Bill 35 (3rd C.S.): Electric Utility Restructuring Oversight Committee*

This Act reconciles differences between House Bill 1948 and Senate Bill 1418 enacted in the 78th Legislature, Regular Session. It reenacts and amends provisions of the Utilities Code to clarify the membership of the Electric Utility Restructuring Oversight Committee, which was created to oversee the implementation of Senate Bill 7 enacted in the 76th Legislature. The committee includes three senators appointed by the Lieutenant Governor, the chair of the House Committee on Regulated Industries, and two other House members appointed by the Speaker of the House of Representatives. The Act provides that one of the three senators designated by the Lieutenant Governor and chair of the House Committee on Regulated Industries serve as joint chairs of the oversight committee. The effective date of this legislation is October 13, 2003.

##### 2. *House Bill 1369: Local Registration of REPs*

House Bill 1369 amends the Utilities Code to require the PUC to adopt standard municipal registration requirements for REPs. The rules adopted by the PUC must be consistent with and no less effective than federal law and may not require the disclosure of highly-sensitive competitive or trade secret information. The effective date of this Act is September 1, 2003.

##### 3. *House Bill 1531: Powers and Duties of Gas and Electric Corporations*

Section 181.001(1) of the Texas Utilities Code was amended to include a master limited partnership and a limited partnership in the definition of a corporation. The Act includes in the definition of "corporation" any entity that is an electric or gas utility, regardless of the form of business organization. The effective date of the Act is June 20, 2003.

---

248. *Id.* at 640.

4. *House Bill 2006: Construction and Maintenance of Facilities Along, Over, Under, or Across Railroad Right-of-Ways*

This Act adds a new subchapter to the Utilities Code concerning construction and maintenance of certain facilities along, over, under, or across a railroad right-of-way. It authorizes a utility, a common carrier, a cable operator, or an energy transporter to acquire an easement by eminent domain to use a railroad right-of-way if the entity provides notice to the railroad and does not unreasonably interfere with railroad operations. The railroad may require the entity to relocate a facility in the right-of-way under certain conditions. If the railroad requires the entity to obtain a right to use the right-of-way, the railroad, upon request in writing, is required to produce documentation indicating the extent of the railroad's right, title, or interest in the property, and the entity is required to reimburse the railroad for the cost of producing the documentation, not to exceed \$500. If the entity obtains the right to continuously use a railroad right-of-way through the exercise of eminent domain, the award of damages due the railroad is the market value of the property plus any damages to the railroad's remaining property. The Act authorizes the railroad to recover certain other costs and establishes restrictions on payment of costs awarded against a railroad in condemnation. A time period is specified during which the railroad is prohibited from requiring the entity to remove an existing facility if certain conditions are met. The Act authorizes the entity to pay a one-time fee to obtain an original license or renew a license for the right to use a railroad right-of-way. The effective date of the Act is September 1, 2003.

5. *House Bill 2548: Construction of Transmission and Distribution Facilities*

Under PURA, it is unclear whether the PUC has the authority to order a public utility to construct transmission and distribution infrastructure. House Bill 2548 amends Section 39.203(e) of the Utilities Code to authorize the PUC to order the construction of such transmission and distribution facilities in order to reduce transmission constraints within ERCOT territory, where such constraints are not being resolved by other specified means. The Act authorizes the PUC, notwithstanding Section 36.054(a) of the Utilities Code, to order the inclusion of construction work in progress in the rate base for transmission and investment required by the PUC under Section 39.203(e), if the PUC determines that conditions warrant such an inclusion. The PUC is also authorized, in granting a CCN, to consider to the extent applicable the effect that granting the CCN will have on the state's goal for expansion of renewable energy generating capacity. The effective date of this legislation is June 18, 2003.

6. *Senate Bill 1280: Regulation of Successors to Electric Cooperatives*

Previous law exempted electric cooperatives from competition unless a cooperative's governing body elected to provide customer choice. Senate

Bill 1280 removes language pertaining to successors of electric cooperatives from the definition of “electric cooperative” in Section 11.003 of the Utilities Code and repeals the special rate provisions applicable to them. For utilities before September 1, 2003 that were not subject to the chapter restructuring the electric utility industry, the Act establishes regulatory oversight by the PUC and authorizes the PUC to establish related schedules and procedures. The effective date of Senate Bill 1280 is September 1, 2003.

## B. GAS UTILITY

### 1. *House Bill 1193: Repeal of Annual Gas Utility Report*

Section 121.156 of the Texas Utilities Code requiring that the Railroad Commission make an annual report to the governor on gas utilities is repealed. This report is no longer required because (1) the funding of regulatory activities for gas utilities is now performed through the normal agency budgeting process and (2) regulatory activities and expenditures are reported through the Railroad Commission’s annual statistical and financial reports. The effective date for this legislation is June 20, 2003.

### 2. *House Bill 1194: Annual Inspection Fee for Natural Gas Distribution Companies and Master Meter Pipelines*

Section 121.211 of the Texas Utilities Code is amended to allow the Railroad Commission to impose fees on natural gas distribution and master meter operators to fund the Commission’s pipeline safety program. Currently, the pipeline safety program is funded through appropriations of general revenue and federal funds. The federal program is a matching program intended to fund approximately fifty percent of the cost of the program. The Railroad Commission may assess each investor-owned and municipally-owned natural gas distribution system an annual inspection fee that may not exceed fifty cents for each service line reported on the Distribution Annual Report. The Railroad Commission also may assess each operator of a natural gas master-metered system an annual inspection fee not to exceed \$100 for each master-metered system. The Act requires each investor-owned and municipally-owned natural gas distribution company and each natural gas master-meter system operator to recover as a surcharge to its existing rates the amounts paid to the Commission under this section. The effective date of the Act is September 1, 2003.

### 3. *House Bill 1575: Cost-Based Transportation Rates for Natural Gas*

This Act amends the provisions of the Utilities Code concerning the requirement that utilities provide natural gas at certain rates to school districts. It expands the requirement to include all “public retail customers,” which are defined as state agencies, higher education institutions, public school districts, or political subdivisions. The Act also provides

that if a municipally-owned gas utility and a public retail customer are not able to reach an agreement on a contract rate, the rate may be determined by the relevant regulatory body under the law governing rates and services. The effective date of this legislation is June 20, 2003.

4. *House Bill 2846: Gas Utility Contested Case Hearings*

This Act repeals Utilities Code Section 102.006 and Government Code Section 2003.0491, which required the SOAH to conduct hearings for all contested case gas utility rate cases that are not conducted by one or more members of the Railroad Commission of Texas. The effective date of House Bill 2846 is June 18, 2003.

5. *Senate Bill 1271: Incentives to Encourage Gas Utilities to Invest in New Infrastructure*

Currently, a utility must wait until the next rate case to begin recovering on any investments made during the interim between rate cases. Regulators base rates on the operating expenses of the utilities and a reasonable return on their investment in facilities. Rate cases are very expensive to prosecute. This Act allows a utility to start recovering on new investments in the year following completion of construction. The effective date of Senate Bill 1271 is September 1, 2003.

#### IV. CONCLUSION

The cases and statutes surveyed in this article should provide attorneys with a guide to significant developments in utility law, primarily in the area of deregulation of the electric utility market. The cases demonstrate that the courts are currently in the process of interpreting the statutes and rules that are a necessary part of the transition from a regulated market to a competitive electricity market in Texas.